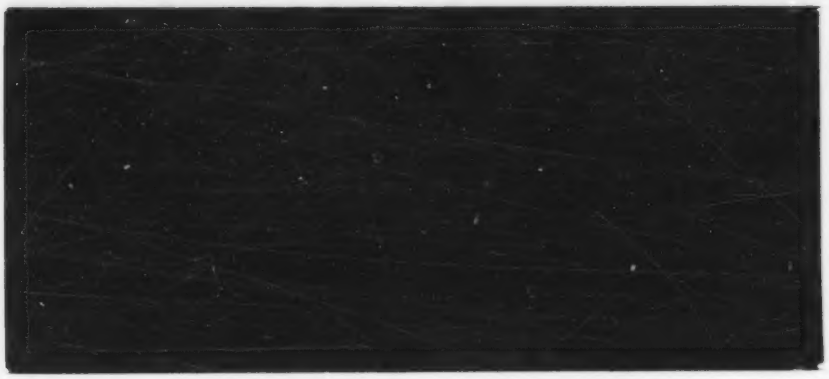
Working Paper

Document de travail



Fiscal Policy and
Economic Analysis
Branch

Department of Finance

Direction de la
politique fiscale
et de l'analyse économique

Ministère des Finances

101-06206/

Resolutions of the U.S. Trade Imbalances: How Painful Will the Adjusment Be?

by

Janice Haritos

Working Paper No. 88-6

Economic Analysis and Forecasting Division
Fiscal Policy and Economic Analysis Branch
Department of Finance, Canada

Working papers are circulated in the language of preparation, to make analytic work undertaken in the Department of Finance available to a wider readership. They have received only limited evaluation and do not necessarily reflect the views of the Department of Finance. Comments on

ABSTRACT

A lot of concern is currently being expressed about the magnitude of the U.S. current account deficit and the manner in which an improvement may occur. The views expressed typically range from catastrophic (Peter Peterson, "The Morning After") to pessimistic (Benjamin Friedman, "Day of Reckoning"). They all share a common theme that the adjustment must of necessity be painful, entailing a severe curtailing of American living standards.

The attached paper analyses these arguments and summarizes the work done in the Department of Finance on this crucial issue. While our conclusion is that an improvement in the U.S. current account deficit will require a curtailment of living standards, the outcome does not necessarily have to be catastrophic or even pessimistic. Indeed, in the right environment, in which the U.S. government lowers its fiscal deficit and there is an appropriate international policy cooperation, the external sector of the U.S. could move to a position of sustainability (in which growth in net foreign debt is no greater than growth in GNP) without a drastic cut in individual living standards.

Simulations carried out on the Department's econometric model of the U.S. economy show that, in order to bring about a correction in the U.S. trade balance whereby the foreign debt-to-GNP ratio is stabilized by 1994, Americans would have to divert 0.6 of a percentage point of their output growth each year over the next five years to foreigners. Given that the potential growth rate of the American economy is estimated to be 2 1/2 per cent, the study shows that even after providing for a level of investment that is high by historical standards, American living standards during the adjustment period could still rise both on a per capita and a per worker basis. Moreover, in such a scenario, the American economy could emerge after the adjustment period in a highly competitive position.

RÉSUMÉ

Les craintes ne cessent de se multiplier au sujet de l'ampleur du déficit du compte courant des États-Unis et des mesures qui pourraient être adoptées pour corriger la situation. Les points de vue exprimés par les experts oscillent entre la catastrophe (Peter Peterson, "The Morning After") et le pessimisme (Benjamin Friedman, "Day of Reckoning"). Tous partagent cependant un thème: l'adaption sera nécessairement douloureuse et elle entrainera une importante baisse du niveau de vie des Américains.

Le document ci-joint renferme une analyse de ces points de vue de même qu'un résumé des travaux effectués par le ministère des Finances concernant cette question fondamentale. Bien que nous en venions à la conclusion que la réduction du déficit du compte courant des États-Unis exigera une baisse du niveau de vie, le résultat ne doit pas nécessairement être catastrophique ni pessimiste. En effet, dans un environement adéquat, dans lequel le gouvernement des États-Unis réduirrait le déficit et la coopération internationale serait suffisante, la position externe des États-Unis pourrait être soutenable (c'est-à-dire que la croissance de la dette étrangère nette ne serait pas supérieure à celle du PNB) sans que le niveau de vie des particuliers ne soit durement touché.

Les simulations faites avec le modèle économétrique de l'économie américaine du Ministère révèlent que pour corriger la balance commerciale des États-Unis et stabiliser le ratio dette étrangère au PNB d'ici 1994, les Américains devraient réorienter 0.6 point de pourcentage de la croissance annuelle de la production au cours des cinq prochaines années vers l'étranger. Vu que le taux potentiel de croissance de l'économie américaine est évalué à 2 1/2%, l'étude indique que même en prévoyant un niveau d'investissement plus élevé que d'habitude, le niveau de vie des Américains, par habitant et par travailleur, pourrait quand même augmenter au cours de la période d'adaption. En outre, dans une telle situation, l'économie américaine pourrait être très compétitive après cette période.

RESOLUTION OF THE U.S. TRADE IMBALANCE: HOW PAINFUL WILL THE ADJUSTMENT BE?

I. INTRODUCTION

The emergence and persistence of huge current account imbalances in the international economy remains a matter of central concern to economic policymakers. The potentially dire consequences of the huge U.S. current account deficit - which mushroomed from a small surplus in 1981 to a record deficit of $154 billion in 1987 -- has been the topic of much discussion both in the press -- as typified by Peter Peterson's article "The Morning After" published in the October 1987 issue of the Atlantic Monthly[1] as well as the subject of many analytical papers such as those produced by Fred Bergsten and Stephen Marris of the Institute for International Economics.[2] The most recent of these gloomy prognostications for the American economy is contained in a just-released book authored by Benjamin Friedman, an economics professor at Harvard, entitled "Day of Reckoning".[3]

All of these articles take as their major theme that Americans have been on a very long binge of living beyond their means by running up a huge foreign debt and selling off assets, with the tab billed for the future. Since Americans cannot go on borrowing from foreigners at their current rate of 3.4 per cent of GNP per year to finance their consumption -- such borrowing combined with accumulating debt service would imply a staggering $3 trillion in net debt by the year 2000 -- the time has now come when Americans must sharply curtail their consumption and export more than they import in order to halt the debt buildup.

Some economists -- such as Bergsten and Marris -- see the "day of reckoning" in which Americans pay for past profligacy compressed into a sharp and deep global recession triggered by a free fall of the dollar, a collapse of financial markets and a sharp rise in interest rates. Others believe that what lies ahead is a protracted period of reckoning with the U.S. paying for past fiscal sins with a very long period of substandard growth. In their view, the main worry is not the prospect of a brief period of economic recession, but a protracted time of economic troubles insufficiently concentrated to inspire correction in what will remain a profligate fiscal course.

---

1. Peter Peterson, "The Morning After", The Atlantic Monthly, October 1987. For example, see also, "It's Time for America to Wake Up" and "The New Economy: Say Hello to the Lean Years", Business Week, November 16, 1987.

2. Stephen Marris, Deficits and the Dollar, The World Economy at Risk, Washington: Institute for International Economics, Dec. 1985, Updated August 1987.

3. See "Day of Reckoning Could be Long, Subtle", Wall Street Journal, June 13, 1988.

Either way, there is a general sense that the upshot will be an inevitable diminishing standard of living for most Americans. According to calculations by Peter Peterson, Americans will have to undergo a painful reduction in their standard of living, as they are forced to consume less than they produce not only to pay a large and rising debt service load but to also bring the merchandise trade account into surplus in order to halt the growth of the foreign debt.

The first part of this paper presents a retrospective on the U.S. savings and investment experience in the 1980s and the buildup in the U.S. foreign debt which occurred as foreign capital inflows rose to fill the growing gap between domestic savings and investment over that period. The second part of the paper attempts to provide an assessment of how painful the unwinding of the U.S. external imbalance might be assuming that internationally co-ordinated policy actions lead to a rebalancing of world demand in such a way which avoids a decline in economic activity.

II. THE U.S. SAVINGS-INVESTMENT IMBALANCE OVER THE 1980S

The Rise of the U.S. Trade Deficit

As Chart 1 below shows, the U.S. current account deteriorated from a small surplus in 1981 an unprecedented deficit of $154.0 billion in 1987 or 3.4 per cent of GNP. As a result of the continued large current account deficits since 1982, the recorded net international investment position of the U.S. deteriorated from a net creditor position of $171 billion in 1981 to a net debtor position of $368 billion in 1987 or approximately 10 per cent of GNP.

There appears to be general agreement among analysts that an unprecedented mismatch between domestic and foreign policy was primarily responsible for the emergence and rise of the U.S. trade deficit in the 1980s. Recent studies suggest that a combination of expansive fiscal policy and monetary contraction in the U.S. and fiscal contraction abroad can explain about two-thirds of the rise in the U.S. trade deficit[4]. A decline in the U.S. national savings rate - brought about by a rise in the federal deficit and the accompanying rise in government borrowing - drove up real interest rates in the U.S. which attracted funds from around the world to dollar securities and thereby raised the exchange value of the dollar. The strong dollar, coupled with stronger growth in U.S. domestic demand (fueled by the fiscal expansion) relative to demand growth abroad led to the rise in the trade deficit.

The fiscal-monetary policy mix was not the only reason for the rise in the real value of the dollar. The 1981 change in tax rules and higher after-tax return on corporate investments, and stronger growth in the U.S. relative to Europe increased the attractiveness of U.S. investment to foreigners, and the inflow of capital it stimulated probably also contributed to the appreciation of the dollar and the deterioration in the trade deficit. Finally, the deterioration of the Latin American debt situation discouraged additional lending to developing countries and the increased relative safety of claims on American capital may have also been a contributing factor to reduced capital outflow/higher inflow and the trade deficit.

The Decline in the U.S. National Savings Rate

When a foreign net capital inflow is used to finance productive investment, even a relatively large and persistent inflow need not be a cause for concern. The higher returns from the investment in productive assets financed by the capital inflow can generate the income to pay foreign creditors. Moreover, because of taxes and for other reasons, the entire return from investment is not always paid to creditors.

However, as Table 1 below shows, the surge in the U.S. trade deficit has not been matched by an increase in the share of American GNP devoted to investment. Gross investment as a share of GNP averaged 16.4 per cent over the five year period from 1983 to 1987, about the same as its average share over the 1970-80 period. Instead, the expansion of the trade deficit was matched by increased consumer spending: personal consumer expenditures rose from 62.7 per cent of GNP over the 1970s and early 1980s to 65.6 per cent of GNP over the 1983-87

---

4. See Peter Hooper and Catherine Mann, "The U.S. External Deficit: Its Causes and Persistence", paper prepared for Conference on "The U.S. Trade Deficit-Causes, Consequences and Cures", Federal Reserve Bank of St. Louis, October 1987.

   Also, K.G. Lynch, "The International Macroeconomic Outlook and Policy Issues", paper presented to the John Deutsch Policy Forum on the Macro Policy Issues in the Medium-Term, April 18, 1988.

period, a rise of 2.9 percentage points and equivalent to the rise in the current account deficit from approximate balance in the late 1970s and early 1980s to 2.8 per cent of GNP over 1983-87. Thus, the increase in foreign borrowing over the 1980s has in effect been used to finance U.S. consumption rather than capital formation.

Table 1

U.S. Consumption Investment and Current Account Balance
(as % of GNP)

	1960-69	1970-80	1981-87	1983-87
Gross Investment/GNP	15.5	6.7	4.7	5.5
Consumption/GNP	62.7	62.7	65.0	65.6
Current Account Balance/GNP	0.4	0.0	2.3	2.8

On the flip side of the coin, the U.S. "overconsumption" problem is mirrored in the dramatic decline in the U.S. national savings rate during the 1980s. As shown in Table 2, the U.S. national savings rate declined sharply during the 1980s, falling from an average level of nearly 7 per cent over the 1970s to an average of 2.5 per cent of GNP over the past four years. The American savings rate is about half the rate of the U.K., about 40 per cent of the rate in Canada and 30 per cent of the rate in France and Germany, and only 10 per cent of the rate in Japan.

Table 2

U.S. Domestic Savings

	1970-80 (1)	1981-87 (2)	1983-87 (3)	Change (3) - (1)
Total Domestic Savings/GNP	6.8	2.8	2.4	-4.4
Private Savings/GNP	7.8	5.7	5.6	-2.2
Government Savings/GNP	-1.0	-2.9	-3.2	-2.2
Federal Savings/GNP	-1.8	-4.2	-4.5	-2.7

The unprecedented U.S. federal budget deficits in recent years have been singled out for blame for the decline in the national savings rate. Total government dissaving increased by 2.2 percentage points of GNP between the 1970-81 period and the 1983-87 period. A lesser known fact is that the government deficit accounts for about only one-half of the decline in the national savings rate between these two periods. The remainder is attributable to a roughly equal decline in the private savings rate, with most of the decline traceable to a fall in the personal savings rate between the two periods. The private savings rate as a per cent of GNP fell from an average rate of 7.8 per cent in the 1970-81 period to 5.6 per cent in the 1984-87 period, a decline of 2.2 percentage points.

Implications of Maintaining a Low Level of National Saving

Textbook models of open economies suggest that the level of national saving has no impact on the level of national investment, because decreased saving is translated dollar for dollar into international borrowing. Nevertheless, it is highly doubtful that international capital inflows can substitute for domestic saving on a long-term basis:

- Most observers would agree that U.S. current account deficits of $100 billion or more are not sustainable. Current account deficits in this range imply mushrooming debt-servicing costs and a rising debt-to-GNP ratio -- a major criterion by which debtors assess the indebtedness of a country relative to its ability to pay. Foreigners would come to regard the U.S. as too heavily indebted relative to its ability to pay and would become unwilling to hold claims on the U.S. at current interest and exchange rates.

- The judgement that large-scale capital import is not viable as a long-run strategy is confirmed by international experience. Martin Feldstein and Charles Horioka[5] have shown that there is

5. Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows", Economic Journal, Vol. 90 (June 1980).

a near-perfect correlation between national saving and investment rates, although the reasons for the close association are not clear. One plausible reason is that because capital flows cannot take place without large changes in patterns of domestic production, the consequent economic dislocations create substantial pressure to bring saving and investment into balance, and sooner or later the government adjusts its policies accordingly.

- Finally and most importantly, even if strong U.S. investment could be financed by foreign saving, the level of future U.S. living standards would still depend primarily on the national savings rate. While investment financed by foreigners could still bring substantial benefits to Americans, the additional investment financed by foreigners would be matched by a rise in foreign debt and associated debt servicing costs, and by increasing foreign ownership of American industry, whose profits would be repatriated to the home country.

By How Much Must the U.S. Current Account Deficit Improve?

While there is a general consensus that the U.S. external imbalance must improve, there is no consensus as to how much and how fast the current account deficit must decline:

- Many observers believe that the U.S. must halt its debt accumulation which means that the U.S. must eventually reduce its current account deficit to zero. This implies that the U.S. must run a surplus on merchandise trade and non-factor services in order to finance the interest and dividends on the debt that Americans will owe investors abroad. Holders of this view emphasize the need to begin cutting the trade deficit soon before the cumulative debt builds too much.

- Others question whether an objective of current account balance by the mid-1990s is necessary. In their view, sufficient savings will likely be available from abroad well into the next decade to finance some amount of the U.S. external deficit at an appropriate set of relative interest rates and exchange rates given the longer-term needs of some European countries and Japan to provide for aging populations by investing in economies with higher long-term rates of return and growth prospects.

- If the criterion of a stable debt-to-GNP ratio is used as a guide as to what constitutes a sustainable capital inflow and debt accumulation, then perhaps a more realistic goal is to stabilize the U.S. debt-to-GNP ratio by 1994 (which implies a current account deficit of about $60 billion or 0.8 per cent of GNP).

- According to estimates by the OECD Secretariat[6], net holdings of U.S. dollar assets of the non-U.S. private sector amount to about $600 billion. If this portfolio is growing at a rate of approximately 10 per cent per year, (a not unduly optimistic assumption insofar as financial liberalization is enlarging the number of participants in international finance), then a net demand of $60 billion per year would stabilize the share of dollars in foreign portfolios.

- The view that the U.S. need not eliminate its current account deficit over the next few years takes on even more probability in view of the fact that concerns about the size of net foreign claims on the U.S. may be overstated. In 1987, the U.S. received income of $5.4 billion more on assets owned abroad than it paid on foreign-owned assets in the U.S. The excess of receipts over payments reflects, in part, undervaluation of U.S. assets abroad (especially direct investments made years ago that are valued at historical cost) as well as a generally higher rate of return on U.S. owned assets abroad than on foreign owned assets in the U.S. In terms of income received and paid, the U.S. was a net creditor in 1987.

III. MUST AMERICAN LIVING STANDARDS DECLINE DURING THE ADJUSTMENT PROCESS? SOME ILLUSTRATIVE SCENARIOS

The U.S. has already begun the adjustment process of reducing its trade imbalance, entering a sustained period during which U.S. domestic demand must grow slower than U.S. production. U.S. household and government consumption must expand at an even slower rate than domestic demand in order to free up resources to not only close the trade gap but also to provide the resources necessary to sustain the high level of investment needed to expand the productive capacity of the U.S. economy and raise productive efficiency.

This section examines the probable magnitude of adjustment required in American living standards over the next seven years (1988-94) to bring about either a partial correction or balance in the U.S. external accounts. To do this, we have used the Department of Finance model to illustrate plausible paths of the U.S. economy under two alternative scenarios. The first scenario depicts only a partial adjustment of the U.S. fiscal and external imbalances by 1994, with the current account deficit falling to the point where the external debt-to-GNP ratio is stabilized (a current account deficit of about $65 billion by 1994 stabilizes the debt-to-GDP ratio at .15). The second scenario assumes that the current account is brought back into balance by 1994.

---

6. OECD Secretariat, The Financing of International Imbalances, WP3 of the Economic Policy Committee, June 1988.

A basic premise of this analysis is that correction of the international imbalances is brought about by co-operative policy action which permits the U.S. output to achieve its potential growth rate rather than a market driven solution which would in all likelihood result in a substandard rate of growth for the global economy over the next several years. The key features of this smooth adjustment scenario are:

- The U.S. fiscal authorities begin to narrow the disparities in domestic demand levels through a significant reduction in the U.S. budget deficit. It is also assumed that a partial reversal in the factors which have led to a decline in recent years in the U.S. private savings rate -- demographic wealth and other factors -- will lead to some rise in the personal savings rate over the coming years.

- Tighter fiscal policy in the U.S. is offset by easier monetary policy. Easier monetary policy and a rise in the U.S. national savings rate allows interest rates to decline significantly. Lower interest rates and the demand effects of strong net exports fuel a strong rate of investment growth over the projection period.

- Lower interest rates (and interest rate differentials) with other countries lead to a gradual depreciation of the dollar, with the dollar declining at about the same rate as the interest rate differential between the U.S. and other economies. The lower dollar facilitates the switching of world (and U.S.) expenditure towards American-produced goods and reinforces the restraining impact of tighter fiscal policy and slower domestic demand growth on U.S. import demand.

- Strong investment over the projection period supports solid productivity growth in the U.S. It is assumed that output per worker, as measured by real GNP per employee, rises at an annual rate of 1.2 per cent over the projection period. While this rate of productivity growth is higher than the 0.9 per cent annual growth in productivity registered over the 1980s, it is considerably lower than 2 1/2 per cent productivity growth rate experienced in the 1950s and 1960s. Coupled with labour force growth of 1.3 per cent per annum, the U.S. economy grows roughly at its potential growth rate of 2 1/2 per cent over 1988-94.

It should be stressed that the future rate of productivity growth is a key factor in determining whether the U.S. trade deficit can be corrected without inflicting a painful adjustment in American living standards. While productivity growth has recovered in the 1980's from its slump in the 1970's (the recovery has been confined mainly to the manufacturing sector), many economists remain skeptical that recent productivity gains mark any fundamental improvement in U.S. productivity performance.

However, there are many factors which suggest that the prospects for U.S. productivity growth are good. These include a growing proportion of mature and experienced persons in the workforce, higher levels of R&D spending relative to GNP in recent years, the beneficial

impacts of deregulation and tax reform, lower real energy prices, a shift of production towards the high productivity goods-producing sector of the economy over the next few years and as noted above, a robust pace of investment-to-GDP and investment-to-employment over the 1980s which is projected to continue into the 1990s.

Impact of Trade Adjustment on U.S. Living Standards

The nominal current account deficit was $154 billion in 1987 whereas the real net export deficit was $129 billion. To balance the current account deficit by 1994 would require more than a $154 billion swing in the nominal merchandise (and non-factor service) trade deficit because net interest and dividend outflows on the net external debt would rise to about $30-35 billion by then.[7] Thus a swing of about $190 billion is needed in the nominal trade deficit.

However, an even greater swing is required in the transfer in real resources. Because import prices are rising faster than export prices due to the dollar's depreciation, the trade balance must improve more in real terms in order to effect the required nominal improvement. Our calculations -- based on relatively optimistic assumptions for the income elasticity of American demand for imports and trade price elasticities[8] -- suggest that a swing in the real trade balance of

---

7. According to some analysts (Lipsey and Smith, 1987), a net U.S. international indebtedness position of $1 trillion would give rise to foreign servicing outflows of $50-100 billion. Our calculations suggest, however, that a net indebtedness of $1 trillion would give rise to net interest and dividend payment outflows of only $30-35 billion, reflecting the fact that the return on U.S. assets abroad will continue to be somewhat higher than foreign-owned assets in the U.S. and that a depreciating U.S. dollar will continue to inflate the earnings received from U.S. investment overseas.

8. The U.S. model's trade sector equations have relatively conventional long-run price elasticities for non-oil goods of about -1.0. It is important to note, however, that the income elasticity of the U.S. imports equation has been ramped down gradually over the projection period from an econometrically estimated value of 2.5 to 1.5, so that it is equal to the income elasticity of foreigners for U.S. exports.

   The income elasticity of U.S. imports is a highly critical parameter in the whole issue of resolving the U.S. trade deficit. A higher income elasticity of 2.5 would imply that the improvement in the U.S. trade deficit could only be achieved at the cost of much slower growth in the U.S. economy. Our imposition of a lower elasticity is based on evidence which suggests that structural factors which raised imports relative to income over the historical period will not continue with the same prominence over the coming years.

$270 billion 1982 dollars would be required to bring about the required nominal trade improvement. This represents an adjustment of about 6 1/2 per cent of real GNP.

Thus, Americans will have to divert to foreigners about 40 billion 1982 dollars per year or close to 1 percentage point of output growth each year through to 1994. In other words, Americans must restrain domestic demand growth 0.9 percentage points below output growth over the next seven years in order to balance the current account by 1994.

In the case of the partial adjustment scenario, whereby the debt-to-GNP ratio is stabilized by 1994, a real swing of $185 billion is needed in the real trade deficit in order to reduce the current deficit to $60 billion by 1994. This amounts to a diversion of about 0.6 of a percentage point of output growth each year to foreigners.

Moreover, in order to raise productive efficiency and provide the capacity that is needed to raise net exports, Americans will have to maintain a level of investment that is high by historical standards. This projection assumes that Americans will devote 0.4 percentage points of output growth each year to 1994 to investment, an amount equal to that of the 1950s and 1960s, but higher than the 0.2 percentage points of the 1970s and 1980s.

Table 3 below presents the projected annual growth rates in real output, domestic demand and absorption under both scenarios. The partial adjustment scenario indicates that with real GNP growth of 2 1/2 per cent (about the pace most analysts consider to be potential growth), U.S. absorption could increase by 1.5 per cent per year, with 0.6 percentage points of output growth diverted to the external sector and 0.4 percentage points devoted to domestic investment. The full adjustment scenario shows that absorption could rise by 1.2 per cent per year, with 0.9 percentage points of output growth diverted to foreigners and 0.4 percentage points earmarked for investment.

Table 3

Projected Growth in Output,
Domestic Demand and Absorption, 1988-94
(Average annual growth rates)
($1982)

				1988-94	
	1966-73	1973-80	1981-87	Scenario 1	Scenario 2
Real GNP	3.3	2.4	2.9	2.5	2.5
Total Domestic Demand	3.3	2.0	3.6	1.9	1.6
Absorption*	3.0	2.1	3.3	1.5	1.2
Consumption	3.6	2.5	3.2	1.9	1.6
Government	1.5	1.2	3.7	0.1	0.0
Absorption per Worker	0.7	-0.2	1.4	0.2	-0.1
Absorption per Capita	1.2	0.2	2.1	0.8	0.5

* Defined as government plus household consumption.

In the partial adjustment scenario, U.S. living standards as measured by absorption per worker can still rise, albeit slowly, over the next seven years. The full adjustment scenario, however shows that while absorption per capita can rise 0.5 per cent per year, absorption per worker must decline by 0.1 per cent per annum or about $40 per year per worker (1982 dollars).

While the prognosis that growth in American living standards must slow dramatically over the next seven years is not a happy one after the rapid growth in consumption enjoyed over the previous seven years, it is mitigated by the following factors:

- Although absorption per worker will not show much improvement or may even decline slightly, absorption per capita can still increase at an annual rate of 0.5 to 0.8 per cent. Thus changes in living standards as measured by absorption per worker or per capita would outperform changes in living standards over the 1973-80 period.

- The hardship imposed by the trade adjustment is mitigated by the fact that consumers will enter this period with a large stock of new durables, particularly cars, and housing as a result of the spending splurge since 1982.

- Both scenarios assume a rate of gross investment stronger than that experienced over the historical period after 1960. Thus, the U.S. will emerge from the 1988-94 period with a tremendous increase in its productive base.

- Both projections embody a very high rate of housing starts; thus, while absorption might be constrained over this period, American living standards would be enhanced by a strong increase in the stock of housing.

- In summary, although American living standards may have to come to a virtual standstill, the U.S. economy would emerge at the end of the 1988-94 period with a current account in or near balance, a stable or falling foreign debt-to-GNP ratio, a strong manufacturing base and a high level of housing and business capital stock.

- While total domestic absorption must be restrained, it should be noted that the more government consumption curtailed, the more room there is left for personal consumption to grow. In the partial adjustment scenario, our calculations show that if government spending were frozen in real terms at current levels, real personal consumption could grow at an annual rate of almost 2 per cent per annum over the next seven years or 1.2 per cent on a per capita basis. In the full adjustment scenario, consumption could rise at an annual rate of 1.6 per cent or 0.9 per cent on a per capita basis.